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UNCLAS SECTION 01 OF 02 MANILA 003156

SIPDIS

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SUBJECT: PHILIPPINE MARKET JITTERS HEIGHTENING

REF: Manila 3061

1. (SBU) Summary: Despite the Philippine Supreme Court's July 5 decision to move up the date of a hearing on the implementation of the recently-passed Expanded Value Added Tax (EVAT), the country's currency, equities, and bond markets remain shaky. Markets are showing increasing signs of strain, as investors appear to be growing weary of continuing political noise, including the resignation of President Arroyo's economic team (septel). Investors also remain concerned about the potential economic impact of the Supreme Court's July 1 decision to place a Temporary Restraining Order (TRO) on the implementation of the EVAT and remain worried about soaring oil prices. The Central Bank announced a hike in reserve requirements to help temper pressure on the peso. End Summary.

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EVAT Hearing Moved Up  
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2. (SBU) On July 5, the Philippine Supreme Court -- responding to the Government's July 4 petition immediately to lift the TRO on the implementation of the amended Expanded Value Added Tax (EVAT) -- voted to move up the date of the hearing of oral arguments from July 26 to July 14 (reftel). However, the Supreme Court did not lift the TRO on the law's implementation. The earlier scheduled hearing date, although welcome, has done little to appease jittery financial markets that are worried about record-high international oil and protracted political controversies.

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Local Currency Continues to Sputter  
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3. (U) The local currency slipped to an intra-day low of PhP56.39/\$1 on July 7 (not far off from the PhP56.45/\$1 all-time low posted before the May 2004 elections) before closing at PhP56.28/\$1, the peso's weakest closing rate since mid-December 2004). As of noon on July 8, the Philippine currency was trading in the PhP56.25-PhP56.44/\$1 range in the interbank market, just shy of the PhP56.45 historic low seen in the run-up to the May 2004 elections.

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Central Bank Hikes Reserve Requirements  
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4. (U) On July 7, the Central Bank announced a two percentage point increase in banks' required reserve requirements, from 19% to 21%, effective July 15. The Central Bank estimates the move to mop up more than PhP30 billion (about \$530 million) from the financial system. In media interviews, Central Bank Governor Amando Tetangco noted that excess financial system liquidity was finding its way into the foreign exchange market and contributing to the peso's weakness, potentially threatening price stabilization efforts. Regular reserve requirements will rise from 9% to 10% and "liquidity" reserve requirements (i.e., reserves that earn market-based returns) from 10% to 11%.

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Stock Market Investors Increasingly Edgy  
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5. (U) The Philippine Stock Price Index (Phisix), which closed at a six-month low on July 4 (1,815.67) following five trading days of consecutive declines, edged up slightly on July 5 to 1,817.02 due to bargain-hunting for select blue-chip stocks. However, the Phisix closed July 6 at a fresh six-month low of 1,813.04 as investors cashed in on profits. Bargain hunting again pushed up

the Phisix to 1,847.32 on July 7. At that level, the Phisix -- touted as Asia's best performer earlier this year -- was up barely 1.4% from the end of 2004 (after having climbed to a 5-1/2 year high of 2,166 in March, up nearly 19% from 2004's closing level). The Phisix opened weaker on July 8 at 1,839.43 and slipped as far as 1,813.99 before closing at 1,876.28, 1.6% higher than July 7's close.

16. (SBU) June still saw net foreign purchases in the stock market despite political jitters, but foreign investors have since turned net sellers in July, to the tune of PhP1.3 billion (\$23 million) thus far. On July 8, net foreign sales (estimated at PhP129 million) continued for the sixth consecutive trading day. The outflows in July are equivalent to about 10% of net foreign purchases during the first half of the year and indicate that investors are becoming increasingly apprehensive about current political and economic developments.

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Bond Spreads Widen  
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16. (U) Spreads for medium- to long-term sovereign bonds narrowed in May with the passage of the amended EVAT. Spreads for medium-term debt papers (i.e., those maturing over next five years) continued to narrow in June despite political disturbances, while spreads for longer-term maturities began to widen with the growing political noise. As of July 7, spreads for government bonds maturing in 2008 had widened by 5 basis points and for bonds maturing in 2025 by 23 basis points, however.

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Comment  
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17. (SBU) The suspension of the EVAT law created more uncertainties for financial markets, already shaken by political disturbances and worries over record-high world oil prices. For now, international reserves remain comfortable -- having climbed to an all-time high of \$17.7 billion in June. Although one local trader/analyst described investors' sentiment as "not yet panicky, but increasingly wary," the situation remains volatile. The disbanding of the country's economic team -- which many had cited as being the strength of the Administration -- only adds to the current volatility. The business sector, credit rating agencies, and other Philippine observers continue to urge a quick resolution to the current controversy, strongly warning that protracted uncertainties will deepen negative perception and increasingly harm the Philippine economy.

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